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Department of the Treasury

1100 Commerce St., Dallas, Texas 75242

Date: MAY 15 1995

Employer ID Number:

Person to Contact:

Telephone Number:

Refer Reply To:

Dear Sir or Madam:

We have considered your application for recognition of exemption from income tax under section 501(c)(3) of the Internal Revenue Code.

The information submitted indicates you were incorporated on [REDACTED]. Your Articles of Incorporation stated that you organized exclusively for charitable, religious, education, and scientific purposes. The specific purpose stated in your Articles was to engage in lawful act or activity for which non-profit corporations may be organized.

In your application, you state that you conduct [REDACTED] research by developing [REDACTED] projects for real property owners and [REDACTED] and [REDACTED]. You indicate your projects are constantly ongoing. They include [REDACTED] projects conducted for commercial and governmental. You perform technical analysis to determine the precise relationship, installation costs, environmental impact, and operating and [REDACTED] and indicate your projects involve [REDACTED] and legislation on the production, distribution and [REDACTED].

You are currently supported through consulting fees paid by your client. You plan to solicit contributions to fund a \$[REDACTED] (minimum) annual scholarship for students interested in energy conservation.

Your services are provided above cost. You state that all funds raised through consulting fees in excess of operating costs will be used to carry on your research. Those research projects will include development of analysis for [REDACTED]. The results of the research will be provided to the public at cost. You will retain all rights to anything you have developed. This includes copyrights, patents and processes from the results of the research projects.

Your operating expenses include salaries, occupancy, telephone, accounting, automobile, and liability insurance. According to your proposed budget, approximately [REDACTED]% of your annual total gross receipts from sales of services will be used to pay a base salary of \$[REDACTED] to your founder, [REDACTED]. You also provide medical insurance to [REDACTED] at a cost of \$[REDACTED] a

[REDACTED]

Besides the base salary and medical insurance, [REDACTED] will also receive a bonus of [REDACTED] % of your total financial support. The sources of your support will include consulting fees, grants and contributions.

Section 501(c) of the Code describes certain organizations exempt from Federal income tax under section 501(a) and reads, in part, as follows:

(3) Corporations, *** fund, or foundation, organized and operated exclusively for religious, charitable, scientific, *** literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals, no part of the net earnings which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation (except as otherwise provided in subsection (h)), and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of any candidate for public office."

Section 1.501(c)(3)-1 of the regulations provides, in part, as follows:

"(a)(1) In order to be exempt as an organization described in section 501(c)(3), an organization must be both organized and operated exclusively for one or more of the purposes specified in such section. If an organization fails to meet either the organizational test or the operational test, it is not exempt."

Section 1.501(c)(3)-1(c)(1) of the Income Tax Regulations provides that:

"An organization will be regarded as "operated exclusively" for one or more exempt purposes only if it engages primarily in activities which accomplish one or more of such exempt purposes specified in section 501(c)(3)..."

"(c)(2) Distribution of earnings. An organization is not operated exclusively for one or more exempt purposes if its net earnings inure in whole or in part to the benefit of private shareholders or individuals."

"(d)(2) Charitable defined. The term "charitable" is used in section 501(c)(3) in its generally accepted legal sense and is, therefore, not to be construed as limited by the separate enumeration in section 501(c)(3) of other tax-exempt purposes which may fall within the broad outlines of "charity" as developed by judicial decisions. Such term includes: Relief of the poor and distressed or of the underprivileged; advancement of religion; advancement of education or science; erection or maintenance of public buildings, monuments, or works; lessening of the burdens of Government; and promotion of social welfare by organizations designed to accomplish any of the above purposes, or (i) to lessen neighborhood tensions; (ii) to eliminate prejudice and discrimination; (iii) to defend human and civil rights secured by law; or (iv) to combat community deterioration and juvenile delinquency."

"(d)(3)(i) In general. The term "educational", as used in section 501(c)(3), relates to -

- (a) The instruction or training of the individual for the purpose of improving or developing his capabilities; or
- (b) The instruction of the public on subjects useful to the individual beneficial to the community.

(d)(5)(i) Scientific defined. Since an organization may meet the requirements of section 501(c)(3) only if it serves a public rather than a private interest, a "scientific" organization must be organized and operated in the public interest. *** Therefore, the term "scientific", as used in section 501(c)(3) includes the carrying on of scientific research in the public interest.***

(d)(5)(ii) Scientific research does not include activities of a type ordinarily carried on as an incident to commercial or industrial operations, as, for example, the ordinary testing or inspection of materials or products or the designing or construction of equipment, buildings, etc."

"(d)(5)(iii) Scientific research will be regarded as carried on in the public interest -

- (a) If the results of such research (including any patents, copyrights, processes, or formulae resulting from such research are made available to the public on a nondiscriminatory basis;
- (b) If such research is performed for the United States, or any of its agencies or instrumentalities, or for a State or political subdivision thereof; or
- (c) If such research is directed toward benefiting the public.***"

"(d)(5)(iv) An organization will not be regarded as organized and operated for the purpose of carrying on scientific research in the public interest and, consequently, will not qualify under section 501(c)(3) as a "scientific" organization, if -

- (a) Such organization will perform research only for persons which are (directly or indirectly) its creators and which are not described in section 501(c)(3).***"

Revenue Ruling 71-506, 1971-2 C.B. 233, provides that an organization formed to engage in scientific research in the areas of heating, ventilating, and air conditioning for the benefit of the general public qualifies for exemption under section 501(c)(3) of the Code. The organization conducts research and studies on a cost basis for universities and government agencies. The results of its research are disseminated through publications. It does not perform commercial tests nor issue reports on commercial products. It maintains a library which is made available to the public without charge. The ruling emphasizes that by operating a library and disseminating the research results, the organization is instructing the public on subjects useful to individuals and beneficial to the community.

Revenue Ruling 71-529, 1971-2 C.B. 234, provides that a nonprofit organization

[REDACTED]

that provides management assistance to participating colleges' and universities; endowment or investment funds for a charge substantially below cost, qualifies for exemption under section 501(c)(3) of the Code. Membership in that organization is restricted to colleges and universities exempt under section 501(c)(3) of the Code. The ruling emphasizes that by providing services to other tax exempt entities for a charge that is substantially below cost, the organization is performing a charitable activity within the meaning of section 501(c)(3).

Revenue Ruling 72-369, 1972-2 C.B. 245, provides that an organization formed to provide managerial and consulting services at cost to unrelated tax exempt entities does not qualify for exemption under section 501(c)(3) of the Code. The ruling emphasizes that an organization is not exempt merely because its operations are not conducted for the purpose of producing a profit. Further, providing managerial and consulting services on a regular basis for a fee is a trade or business ordinarily carried on for profit. The fact that the services are provided at cost and solely for tax exempt organizations is not sufficient to characterize this activity as charitable within the meaning of section 501(c)(3).

Revenue Ruling 75-283, 1975-2 C.B. 201, provides that an organization formed to provide information and technical assistance regarding regulations and laws concerning public housing without charge to any public housing organizations qualifies for exemption under section 501(c)(3) of the Code. The ruling emphasizes that by providing services without charge to public housing tenants the organization is operated exclusively for charitable purposes.

In E.S.W. Group v. Commissioner, 78 TC Docket 6646-77X (1978), the Court upheld the Service's decision that a Delaware corporation formed to provide consulting services for a fee, at or close to cost, to nonprofit organizations and tax exempt organizations did not qualify for exemption under section 501(c)(3) of the Code. Petitioner would furnish consultants to perform basic and applied research for clients. Its fee would be lower than those charged by other firms. It sought to meet all expenses from its consulting income but did not plan to charge a fee less than cost. Despite the public benefit of the services provided by petitioner, the Court concluded that petitioner was not an organization described in section 501(c)(3) because it did not plan to provide free or below cost services to its clients. The primary purpose of its activity was neither educational, scientific, nor charitable, but rather commercial. Another negative factor held against petitioner was failure to limit its clientele solely to organizations exempt under section 501(c)(3).

In People of God Community v. Commissioner, 75 T.C. 127 (1980), the court had to decide whether a percentage compensation arrangement for an organization's minister constituted private inurement. Because there was no upper limit on the amount of compensation the minister could receive, the Court noted that the organization's earnings were being passed on to a private individual. The Court stated that paying over a portion of gross earnings to those vested with the control of a charitable organization constituted private inurement. Thus the Court upheld the denial of exempt status to petitioner.

Based on the information you submitted, we note that your operations can be distinguished from the organizations described in Revenue Rulings 71-529 and

[REDACTED]

75-263, supra. Those organizations provide their services without charge below cost. Further, their services benefit either a distinct charitable or tax exempt organizations. In your case, not only are your services provided above or close to cost, also your services are provided to anyone who can pay your fee, regardless of whether it is a for-profit, nonexempt, or nonprofit entity.

Your primary activities are similar to the activities of the organization described in Revenue Ruling 72-369, supra, in that you are essentially a consulting service and technical advisor to your clients. The ruling concludes that the provision of consulting services for a fee not more than cost is an exempt activity under section 501(c)(3). Also, in B.S.W. Group, supra, the Court held that to provide consulting services at cost or to provide services to organizations which are either nonprofit or tax exempt is not charitable. Therefore, you are not a charitable organization. You are primarily engaged in the business of providing consulting services even though you are organized on a nonprofit basis.

Your primary activities are not educational. You can be distinguished from the organization described in Revenue Ruling 71-506, supra. That organization conducts research for the purposes of educating the public. It does not conduct research incidental to commercial operations. Its research is conducted on a cost basis for universities and government agencies. In your case, not only are your services provided to anyone who can afford your fee, also the results of your studies are not disseminated to the public. Therefore, your activities are not primarily educational. See Regulations 1.501(c)(3)-1(d)(iii), supra.

Also, your proposed activity, the development of software, funded by excess revenue over expenses, does not further scientific or educational purposes within the meaning of section 501(c)(3). You plan to sell your software to the general public. You will retain all copyrights, patents, formulae and processes resulting from your research project. This activity will be indistinguishable from those conducted by a commercial enterprise.

You plan to grant annual scholarships to students who are interested in the study of [REDACTED]. However, this activity has nothing to do with your consulting services because you plan to solicit contributions, a separate source of income, to support your scholarship program.

Further, the compensation arrangement for you founder, [REDACTED], results in private inurement. As stated in People of God Community, supra, when payments are based on a percentage of the organization's gross receipts, there is no limit set on how much the payee can receive under this formula. Therefore, paying over a portion of gross earnings in addition to a base salary to you founder, who has control over your operations, constitutes private inurement. There is no limit on the amount of compensation [REDACTED] can receive from the organization. According to section 1.501(c)(3)-1(c)(2) of the Regulations, supra, an organization will not meet the operational test of section 501(c)(3) if its earnings inure to the benefit of private individuals.

In light of the above, we conclude that you do not qualify for exemption under section 501(c)(3) of the Internal Revenue Code because you are not operated exclusively for one of more exempt purposes within the meaning of that section.

Accordingly, you are required to file federal income tax returns on Form 11

If you do not agree with these conclusions, you may, within 30 days from the date of this letter, file in duplicate a brief of the facts, law, and argument that clearly sets forth your position. If you desire an oral discussion of the issue, please indicate this in your protest. The enclosed Publication 892 contains instructions for filing a protest.

If you do not file a protest with this office within 30 days of the date of this report or letter, this proposed determination will become final.

If you do not protest this proposed determination in a timely manner, it will be considered by the Internal Revenue Code as a failure to exhaust available administrative remedies. Section 7428(b)(2) of the Internal Revenue Code provides in part that, "A declaratory judgment or decree under this section shall not be issued in any proceeding unless the Tax Court, the Court of Claims, or the district court of the United States for the District of Columbia determines that the organization involved has exhausted administrative remedies available to it within the Internal Revenue Service."

If this determination letter becomes a final determination, we will notify appropriate State Officials, as required by section 6104(c) of the Code, and based on the information we have, we are unable to recognize you as an organization of the type described in Code section 501(c)(3).

If you agree with these conclusions or do not wish to file a written protest, please sign and return Form 6018 in the enclosed self-addressed envelope as soon as possible.

If you have any further questions, please contact the person whose name and telephone number are shown at the beginning of this letter.

Sincerely,



Bobby E. Scott
District Director

Enclosures:
Publication 892
Form 6018

Internal Revenue Service
Midstates Region

Department of the Treasury
Appeals Office
55 N. Robinson, Ste. 939
Oklahoma City, OK 73102

Person to Contact:

Telephone Number:

Refer Reply to:

Date JUL 3 1996

CERTIFIED MAIL

In Re:
Denial of exemption

Dear Sir:

This is a final adverse determination with respect to your exempt status under Section 501(c)(3) of the Internal Revenue Code.

You are not organized or operated exclusively for educational or research purposes as defined in the Internal Revenue Code. Specifically you have failed to demonstrate that your activities are distinguishable from that of a for-profit consulting type organization. You have failed to overcome the private versus public nature of your research activities.

Contributions made to your organization are not deductible under Section 170 of the Internal Revenue Code.

You are required to file Federal Income Tax returns with the Austin Service Center for the taxable years for which the filing date of the appropriate return has passed. These returns should be filed within 90 days of the date of this letter unless a request for extension of time is granted. Please send them to the attention of the EP/EO Division, Dallas, Texas, and attach a copy of this letter. Any requests for time extensions should be sent to the Austin Service Center. Processing of an income tax return and assessing any taxes due will not be delayed because a petition for a declaratory judgment has been filed under Section 7428 of the Internal Revenue Code.

We will notify the appropriate State officials, as required by Section 6104(c) of the Code, that based on the information we have available, we are unable to recognize you as an organization described in Section 501(c)(3) of the Internal Revenue Code for the period mentioned.

If you decide to contest this determination in court, a petition for a declaratory judgment proceeding in the United States Tax Court, the United States Court of Claims, or the United States District Court for the District of Columbia must be filed within 90 days from the date this determination was mailed to you.

[REDACTED]

The enclosed Publication 892 provides information about filing suit in the courts.

If you have any questions, please contact the person whose name and telephone number are shown in the heading of this letter.

Thank you for your cooperation.

Sincerely yours,



Ralph G. Messenger
Associate Chief

Enclosure:
As stated